PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

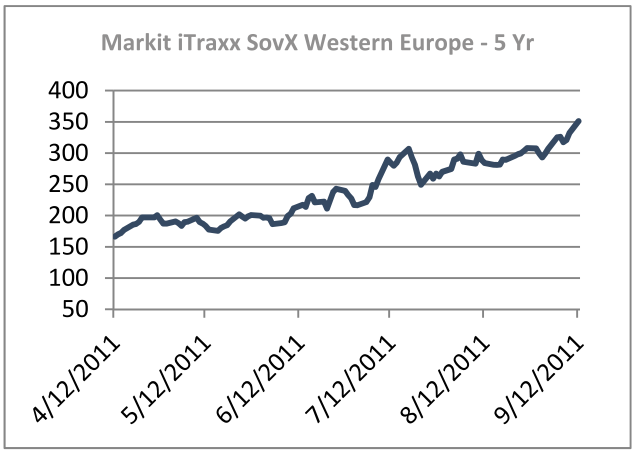
PERMIT CAPITAL ADVISORS, LLC

"The summer wind, came blowin' in, from across the sea..."
Frank Sinatra, "The Summer Wind"

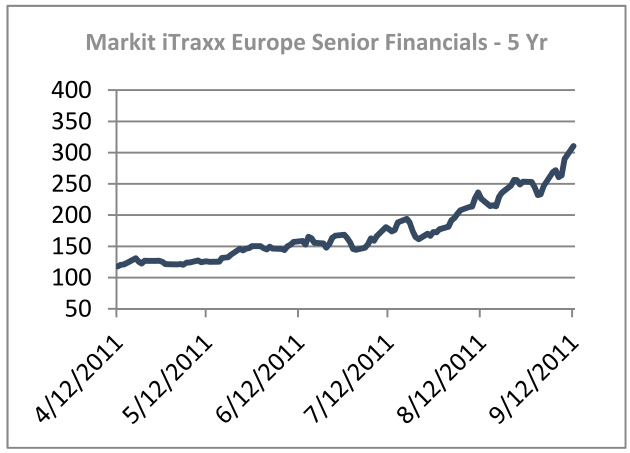
If there was another point in time in which meteorological and financial fortunes ran parallel to one another and were captured in song, we're not aware of it. With respect to the quote above, the figurative winds from a European crisis did indeed come blowing in from across the Atlantic, while literal winds came seemingly from all directions. As summer faded into fall on the east coast, what is normally a fairly serene period was anything but this year. In the span of one week we experienced an earthquake, a massive hurricane, and significant flooding of our streets, homes, and businesses. Hyperbolic claims that signs pointed to the fact that "the world was coming to an end", designed to be commentary about the shock and awe produced by Mother Nature, could easily have been used to describe the debris left behind by global economies and equity markets over the same period. The dual culprits continued to be focused in Europe and the U.S. where structural problems have been continuously exacerbated on a self-inflicted basis by policymakers of political, fiscal, and monetary stripes. Where Alan Greenspan was once said to have given investors a protective put under the market, these leaders, through an inability to tackle problems head-on in a cohesive and lasting manner, seem to have placed a cap on market appreciation and a put under the VIX.[i]

The intensity of the overhang from the two sides of the Atlantic has been the one variable that has shifted in recent times, and for now the finger of blame is pointing more firmly towards Europe. The pressures that originally came to light in the peripheral economies but spread in more recent months to Italy and Spain have not abated, and in fact have intensified of late. The problems continue to intertwine between sovereign debt and the banking system, and are made more dire by virtue of the sheer size of the banking system in Europe. Where the liabilities of banks as a multiple of GDP are under 1x in the US, that figure is significantly higher throughout Europe, more than 2x in both Germany and France, almost 3x in Spain and over 5x in the UK.[ii] Greece continues to reside in the eye of the storm, and for a brief period when data came out showing that the country's budget cap had widened by 22% in the first eight months of the year, it appeared that the next tranche of its bailout package from international lenders was in jeopardy. The announcement of a new two-year property tax that should raise $2.7 billion this year put the payment back on track. The type of meaningful improvement we alluded to above needs to be offered by a combination of the region's larger economies (such as Germany) as well as international authorities governing the region (such as the IMF and ECB). We feel that Eurobonds and a European Financial Stability Facility with teeth would be positive indicators. Both would come with a cost, further indicative of the acceptance of legitimate sacrifice. In exchange for Eurobonds countries would likely need to yield part of their budgetary sovereignty to independent institutions.

The impact of the ups and downs of this drama playing out in Southern Europe is obvious and extensive, and is wreaking havoc on risk assets. Credit default swap (CDS) spreads in the region, which compensate investors looking to protect against a default event, have widened significantly. In the case of sovereign debt, the Markit iTraxx SovX Western Europe Index of CDS was up to 351 basis points while the Markit iTraxx Europe Financial Index of CDS, measuring risk in European banks was at 311 basis points, both record levels.[iii] Closer to home, the palpable sense was that when an investor woke up in the morning and learned what direction CDS spreads on Greek sovereign debt were heading, the dye had largely been cast on the day's market performance. Indeed, according to our calculations since the end of the second quarter through September 12th, the correlation of Greek CDS spreads and the S&P 500 doubled relative to the recent historical norm as measured during the previous five years. Contribution to volatility and big market moves, both up and down, were irrefutable. In the 50 trading days during the previously referenced period, there were 25 sessions in which the S&P 500 moved more than 1%. On those days the movement in Greek CDS spreads was over 20% greater than on days in which the US market was more muted.



Source: Bloomberg



Source: Bloomberg

What this tells us is that our markets are going to continue to be impacted by forces less fundamental to the intrinsic value of its underlying components. While the global nature of the economy grows more entrenched at a rapid pace, the reality is that the fortunes of economies of the scale and scope in question shouldn't be as impactful to U.S. markets as they have been, even with local banking systems hanging in the balance. The reasoning behind the overly forceful impact is twofold in our estimation. First, if affairs become further unglued and we begin to see disorderly defaults and/or exits from the euro zone then we will indeed be faced with a large and systemic global shock. To this point that's not what measures of liquidity are telling us, as spreads like LIBOR/OIS and the TED spread[iv] have increased slightly but sit at a fraction of where they were post-Lehman. Second, what we are squarely in the midst of if not a crisis of liquidity or credit is a crisis of confidence, brought about by the aforementioned leaders of the developed world.

The U.S. contribution to global mayhem continues to come in the form of both prolonged economic weakness and political gamesmanship. The key to real economic recovery, as well as its Achilles heel to date, is the employment situation. The August payroll report informed us that non-farm payrolls were flat, giving us four consecutive months of sub-100,000 gains. We are more than two years into the "recovery" and the needle on improvement in job creation has barely budged. The Economist applied geographical imagery to joblessness in the developed world, explaining that if the 44 million people who are unemployed in the OECD lived in one country its population would be similar to Spain's. In America, the 14 million people officially jobless would form the fifth-most populous state in the union. Add in the 11 million "underemployed", who are working less than they would like, and it is the size of Texas. To further illustrate signs of continuing economic weakness, business investment is barely keeping pace with the rate of depreciation, housing starts are below the rate of household formation and vehicle sales are barely above the historical scrappage rate.[v]

It is no wonder given the data above that we continue to experience the tepid recovery examined by Vince Reinhart, former director of the Federal Reserve monetary-affairs division, and his wife, economist Carmen Reinhart (of Rogoff and Reinhart fame) in a paper presented at last year's Federal Reserve conference at Jackson Hole titled "After the Fall". Comparing our recovery since asset values peaked in 2006 to the recoveries following 15 other post-World War II financial crises of similar severity, the couple found that this 5-year period fell short in real GDP per capita (down 2.2% versus up 3.7% for the median), real equity prices (down 15.6% versus up 4.6% for the median), and home prices (down 37.9% versus down 26.8% for the median).[vi]

While Ben Bernanke has publicly passed the interventionist baton to the fiscal policy camp, there is one likely bullet left in the chamber of the Fed and monetary policy. Operation Twist, first effected by the Kennedy Administration in 1961, has viability amongst a divided Fed largely because it consists of offsetting trades that keep the size of the Fed's balance sheet intact. The maneuver, which involves purchasing longer-term assets while selling shorter-term assets, may have a greater impact at lowering yields at the long-end, which are tied to an array of borrowing costs, than QE1 or QE2. Further, the trade should have a positive skew as short-term rates should rise less than long-term rates fall because Fed holdings amount to a much smaller percentage of the very liquid short end of the curve. Under-3 years Fed ownership of outstanding Treasury securities sits between 10-20% while from 7-10 years the figure is between 35-45%.[vii] While we feel this is likely to be effective as designed, we also believe that its impact on economic conditions is unlikely to be meaningful beyond an initial shot in the arm.

What we continue to trumpet against the backdrop of developed market failings is emerging market successes. This month the emphasis is on economic growth in Brazil. Retail sales figures jumped the most all year in July, as a strong currency and near-full employment buoyed consumer demand. The enviable position of Brazilian economic growth was paired at the end of August with a half point cut to its benchmark interest rate after seeing the rate raised at the previous five policy meetings, as central bank President Alexandre Tombini cited a "substantial deterioration" in the global economy. While the economy's pace is moderating, higher wages are bolstering demand for consumer goods, and, the central bank still has room to cut rates to offer protection and a further impetus for growth. Quite a contrast from the shared experiences of most of the developed world.

While the hope for significant economic growth in the U.S. (enough to meaningfully improve the employment picture) is bleak, we don't believe that we're going to experience a double-dip recession. Unfortunately it's becoming easier for us to envision a scenario in which we continue to misstep our way into one. If we stay on our track of low growth rather than no growth, a case continues to be made for a target weighting to large-cap U.S. equities to be maintained. There are two sets of opposing forces in play which are likely to largely balance each other out, resulting in corporate profits settling at a sustainable trajectory consistent with slow growth. Working for an earnings upside are subdued wage growth, decent productivity, and corporate outsourcing. Working against it are slow economic growth, bad job creation, already elevated margins, and a dollar that is unlikely to drop significantly.

As of August 31, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	-5.4	-1.8	18.5	0.8
Russell 2000	Small Cap Equities	-8.7	-6.5	22.2	1.5
Russell 3000 Growth	US Growth Equities	-5.5	-0.2	24.2	3.7
Russell 3000 Value	US Value Equities	-6.5	-4.4	14.5	-1.5

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
INTERNATIONAL EQUITY					
MSCI World ex US	Global ex US Equities	-8.7	-7.7	7.7	-3.5
MSCI EAFE GR	Developed ex US Equities	-9.0	-5.7	10.5	-1.0
MSCI Europe GR	European Equities	-10.0	-4.7	10.6	-1.1
MSCI Japan GR	Japanese Equities	-8.1	-9.3	6.4	-4.8
MSCI EM GR	Emerging Mrkts Equities	-8.9	-8.3	9.4	8.7

The market also needs to settle on an equilibrium multiple for stocks in a low-growth deflationary environment. If we look overseas for answers, in recent years Japanese equities have traded at 12-13x earnings.[viii] Swiss equities have traded at similar levels for the last ten years with inflation effectively at zero. Clearly there is a paradox of really low interest rates in place: when rates have declined below certain historical levels, investors have tended to demand a higher risk premium.

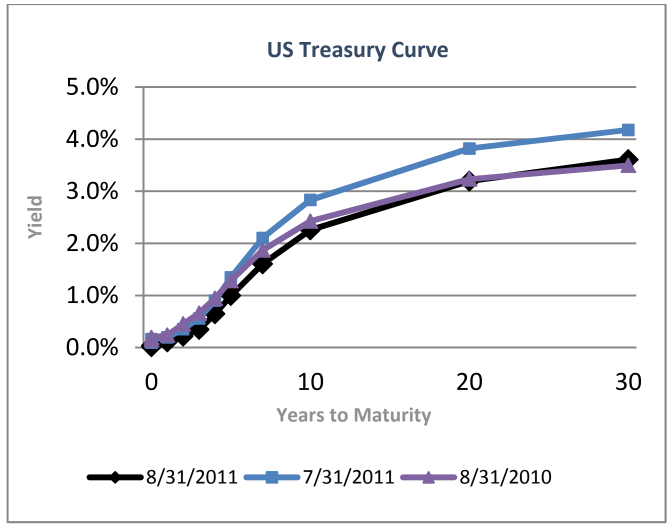
Within the domestic equity universe we feel a compelling case can be made for defensive and traditional value names. Activity levels in the most growth-sensitive sectors has dropped sufficiently to create concern about underlying earnings support. Energy, technology, health care and consumer staples are all enjoying positive growth in hours worked. Conversely, growth sensitive sectors like materials, industrials, consumer cyclicals and financials are experiencing a sharp loss of momentum in business activity.

Looking at fixed income, we continue to have concerns about municipal bonds and optimism about high yield. We've written recently about our thoughts on the problems that surround the municipal bond arena. While we think that the fiscal instability at both Federal and local levels is going to impact the creditworthiness of a significant number of issuers, we believe that the idiosyncratic nature of the asset class presents opportunities for investors willing to evaluate bonds on an individual basis. When issues arise that impact the asset class at an overarching level, that selectivity becomes a neutered tool. One recent instance was the fallout from analyst Meredith Whitney's appearance on 60 Minutes last December. When Whitney predicted "50-100 sizeable defaults" amounting to "hundreds of billions of dollars", many participants in the largely retail-oriented market panicked and dumped their holdings – many in the form of municipal bond funds. This panicked selling pushed municipal bond yields to historical levels relative to fair value measures and, as we communicated to clients in recent PCA Perspectives, we added to positions in portfolios where appropriate. We were rewarded with a reversion towards the mean once panic subsided and research indicating that the prediction was overly dire took over.

As of August 31, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	**Cash**	0.0	0.1	0.1	1.7
BarCap US Agg Bond	**Broad US Investment Grade Bonds**	1.5	5.9	4.6	6.6
BarCap Municipal	**Municipal Bonds**	1.7	7.3	2.7	4.9
BarCap Treasury	**US Treasury Bonds**	2.8	7.0	4.2	6.6
Citi WGBI USD	**Global Sovereigns**	2.1	8.6	9.2	7.9
BarCap US HY Interm	**US High Yield Bonds**	-4.0	1.7	8.0	7.7
JPM EMBI Plus	**Emerging Market Bonds**	0.9	8.2	7.6	8.9

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar



There is another potential scenario looming on the horizon which could affect the municipal bond space as a whole. This one would be another of those that we would put in the 'self-inflicted' category. The Obama Administration's recent $447 billion job-creation plan would pare the tax break for municipal bond interest from 35% to 28% for couples earning more than $250,000 per year. Given the fact that interest in municipal bonds stems largely from their advantageous tax treatment, any diminishment of that formula could reduce investor appetite. We've seen swift resistance to the plan from local-government officials because any reduction in demand for their debt would drive up the interest rates they pay when borrowing for public works. This strikes us as running counter to the broader thrust of the plan which is to create jobs, often stemming from local level infrastructure projects. We're hopeful that the proposed change, which was included unceremoniously on page 136 of the 155-page bill, will be stricken before any form of the plan is passed. If it's not, the dynamics of our municipal bond portfolios will need to be re-evaluated through a new prism.

Where we continue to see opportunity is in the high yield asset class. We've spoken and written at length about the unique characteristics of high yield that make it attractive in this volatile, low growth environment. Much of that value is embedded in the structural nature of high yield in that it can provide yield in a vehicle that is much less interest-rate sensitive than most investors realize. To quantify that notion, an exchange-traded fund (ETF) that consists of Treasury bonds has a correlation to changes in the 10-year Treasury yield of between -95% and -98%, as one would expect. An ETF of investment-grade corporate bonds has a correlation of -49%, indicating that roughly half of the change in value comes from interest rate movement and half comes from credit spread swings. In contrast, an ETF of high-yield bonds has a correlation to 10-Year Treasury yields of +2%. Interestingly, the advent of fixed income ETFs, and more specifically, the derivative options linked to their performance, has given advisors a new tool to evaluate the valuation of high-yield bonds. Implied volatility of put options, or the price to purchase downside protection, is an indicator of how a more institutional breed of investors is pricing risk. In the case of a high yield bond ETF, they are yielding 8.2% with an implied volatility of 20%. By contrast, a long treasury bond ETF yields 3.7% with an implied volatility of 24%.[ix] Further, beyond attractive volatility-to-yield metrics we believe the asset class is well priced to account for economic risk. Gluskin Sheff's Dave Rosenberg estimates that there is a 60% chance of recession already embedded in high yield prices while the equity markets imply only a 30%-50% chance of recession.

As of August 31, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
ALTERNATIVES					
HFRI Fund Wtd. Composite Index	**Broad Hedge Funds**	-2.3	-1.2	7.7	4.2
MLM Index	**Managed Futures**	1.1	5.0	7.3	4.6
DJ UBS Commodity	**Commodities**	1.0	1.3	25.8	0.8
Wilshire US REIT	**REITs**	-5.6	6.4	20.0	-0.4

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

	Latest Month End (8.31.11)	Latest Yr End (8.31.10)	One Year Ago (8.31.10)	Five Years Ago (8.31.06)
CURRENCIES				
US Dollar Index Value	74.12	79.03	83.20	85.05
USD vs. Yen	76.66	81.12	84.20	117.40
Euro vs. USD	1.44	1.34	1.27	1.28
GBP vs. USD	1.63	1.56	1.53	1.90
COMMODITIES				
Gold ($ / ounce)	1825.72	1420.78	1247.45	627.30
Crude Oil ($ / barrel)	88.81	91.38	71.92	70.26
Copper ($ / ton)	9257.50	9650.00	7426.25	7719.00
Corn - Generic (Usd/bu)	757.50	629.00	424.50	232.00

Given the outlook for stocks and bonds, which could probably be described as uncertain at best, we continue to have regular discussions with our clients about the merits of alternative asset classes. Those familiar with our classification schema know that we break alternatives into two categories – directional and non-directional. During the month of August our non-directional alternatives, including gold, managed futures, global macro hedge funds, and fixed income arbitrage hedge funds posted impressive results given the market backdrop. As did non-dollar sovereign bonds, which we include in portfolios because of their decreasing correlations during periods of stress in an effort to provide ballast to our portfolios. We will continue to include these asset classes as structural components of our portfolios to reduce volatility and increase terminal wealth, and will not be afraid to emphasize them tactically in periods of anticipated weakness.

Historically when the outlook has looked most grim, opportunity has often been most ripe. Most often that can only be known in hindsight, but given the rapidity with which the winds of change are blowing across our markets we remain vigilant to the possibility. The upcoming FOMC meeting, on September 20th and 21st, will likely give us our next important signals to decipher. Others will come from developments in Europe with respect to the willingness of political leaders to make challenging political decisions. Similar issues are going to confront U.S. politicians, particular the newly-minted Super Committee of fiscal overseers. Jobs data and, perhaps most importantly, corporate earnings releases will add substance to the conversation we have internally and with clients. We look forward to the opportunity to contribute to these conversations with clients and prospective clients during these turbulent times.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

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[i] VIX is the ticker symbol for the CBOE Market Volatility Index, often referred to as the 'fear index'.

[ii] JP Morgan, Eye on the Market- September 14, 2011

[iii] Source: Bloomberg

[iv] LIBOR/OIS, at 27 bps versus 364 bps at the time of Lehman's fall, and the TED spread (the difference between 3-mo. LIBOR and 3-mo. T-Bills), at 33 bps versus 463 bps at the time of Lehman's fall, both measure stress in interbank lending.

[v] Capital Economics, US Economic Outlook- Q3 2011

[vi] Barron's, QE3 Could Help Get the U.S. Back on Track- September 12, 2011 p.17-18

[vii] BMO Capital Markets, Bond Market Focus- September 12, 2011

[viii] BCA Research, Global Investment Strategy- September 9, 2011 p.5

[ix] Advisor Perspectives, Why High-Yield Bonds Make Sense Today, Geoff Considine, Ph.D.- August 30, 2011